NOT TO BE PUBLISHED IN OFFICIAL REPORTS

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION TWO

PACIFIC TELESIS GROUP, INC., Plaintiff and Appellant, v. FRANCHISE TAX BOARD, Defendant and Respondent.	A104602 (San Francisco County Super. Ct. No. 319008)

I. INTRODUCTION

Plaintiff and appellant Pacific Telesis Group, Inc., challenges a trial court judgment that Pacific Telesis failed to meet its burden of proof that it was entitled to a tax refund from defendant and respondent Franchise Tax Board. Pacific Telesis also contends the trial court erroneously denied its claim for refunds on the basis of various affirmative defenses asserted by the Franchise Tax Board. We conclude Pacific Telesis failed to meet its burden of proof and hence affirm the judgment. We do not, therefore, consider its arguments regarding the affirmative defenses asserted by the Franchise Tax Board.

II. FACTUAL AND PROCEDURAL BACKGROUND

The following factual summary is based largely on stipulated facts agreed to by the parties and adopted by the trial court in its statement of decision.

Until 1984, American Telephone & Telegraph Company (AT&T) owned and controlled the country's telephone system. Pacific Telephone and Telegraph Company

(Pacific Bell) was AT&T's operating company in California. Another member of the AT&T group, Western Electric Company, manufactured telecommunications equipment. Western Electric sold this equipment to the AT&T operating companies, including Pacific Bell.[1]

The tax due on Western Electric's earnings from the sale of this equipment to Pacific Bell during the years between 1967 and 1983 is the subject of this dispute. The tax refunds being sought, however, involve the years 1987 through 1990.

In 1967, the standard federal method for taxing earnings from intercompany transactions, like the ones between Western Electric and Pacific Bell, was set out in section 1502 of the Internal Revenue Code. Under federal Treasury Regulations, the seller, Western Electric, was required to recognize the gain using the "deferral method." (Treas. Regs. § 1.1502-13.) Under this method, Western Electric would have reported to the Internal Revenue Service its gain as taxable income over the years that Pacific Bell was expected to use the equipment. (*Ibid*.) In turn, Pacific Bell would depreciate the equipment on the basis of the amount that it paid to Western Electric. (Treas. Regs. § 1-1502-13(a).) Pacific Bell was entitled to claim depreciation each year based on this tax basis. (Treas. Regs. § 1-1502-13(d)(1).) Under federal tax law, in the event that either Western Electric or Pacific Bell ceased to be a member of the AT&T group, the remaining deferred gain was to be taken into account by Western Electric immediately before this breakup. (Treas. Regs. § 1-1502-13(f)(1)(iii).)

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[1] Until their breakup, AT&T and its subsidiaries were a "unitary business group." A "unitary business" is a "functionally integrated enterprise," the components of which are characterized by substantial mutual interdependence and a flow of value among the companies that comprise the business. Each member of a unitary business is dependent on or contributes to the operation of the entire business enterprise of the group. (*Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 178-179.) A unitary business's profitability, on which its tax liability is based, comes from its operation as a unit, rather than from gains made by each individual entity. No single company is responsible for the income of the unitary business. (*Id.* at p. 181.)

Ultimately, however, neither Pacific Bell nor Western Electric reported and paid tax on the income from Western Electric sales in the manner anticipated by then-existing Treasury Regulations. Instead, apparently in order to benefit Pacific Bell's ratepayers, Pacific Bell and Western Electric entered into an agreement (the "1967 Closing Agreement") with the Internal Revenue Service to shift the reporting and payment of this tax liability.

The terms of the agreement were as follows: Western Electric did not report or pay tax to the Internal Revenue Service on its deferred gain from the equipment sales. Rather, Pacific Bell "reported" the gain by reducing the depreciation deductions it would otherwise have claimed on this equipment. Because it reduced its depreciation deductions, Pacific Bell had greater taxable income and thus paid greater taxes, which offset the taxes Western Electric would otherwise have paid.[2] Under the 1967 Closing Agreement, if Pacific Bell separated from AT&T, Pacific Bell agreed to report any remaining deferred gain from the Western Electric equipment sales.

In 1984, AT&T was required to divest itself of its subsidiaries. Pacific Bell became a subsidiary of Pacific Telesis Group and Western Electric remained a subsidiary of AT&T. In 1985, Pacific Bell entered into a second agreement with the Internal Revenue Service, which revised the manner in which Pacific Bell was to report the gains from Western Electric equipment sales. Under this agreement, Pacific Bell committed to reporting the remaining deferred gain over a ten-year period, from 1984 to 1993, by reducing the amount of depreciation deductions it claimed. Pacific Bell also agreed that, by 1993, it would report all remaining deferred gains.

No statute or administrative regulation specified how the gain from the Western Electric equipment sales should be reported for California tax purposes. Between 1967 and 1983, Pacific Bell and Western Electric reported the income from the Western Electric equipment sales to the Franchise Tax Board in the same way they had reported this income in their federal tax returns. Similarly, after the breakup of AT&T, Pacific

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[2] Western Electric reimbursed Pacific Bell for this increased tax liability.

Telesis filed state tax returns, between 1984 and 1993, which treated the Western Electric equipment sales the same way they had been treated under the federal agreement. There was, however, no written agreement between the Franchise Tax Board and Pacific Telesis or Western Electric authorizing this practice, although there were extensive negotiations looking toward such an agreement.

The statute of limitations for challenging tax returns filed in 1983, including the return filed by Pacific Bell for that year, ran on June 30, 1995. Less than six months later, Pacific Telesis, for the first time, sought to take the full depreciation deductions for the years between 1987-1990 rather than the reduced deductions it agreed to take under its 1985 agreement with the Internal Revenue Service. On December 15, 1995, Pacific Telesis filed amended tax returns in which it sought tax refunds on the ground that it was not required to take the reduced deductions, and, therefore, had overpaid its tax liability by $9,960,422. The Franchise Tax Board denied the requested refunds and, in 2002, Pacific Telesis filed suit for the requested refunds for the years 1987-1990.

After a court trial, on September 9, 2003, the court entered judgment denying Pacific Telesis's refund claim; this timely appeal followed.

III. DISCUSSION

A. *Standard of Review and Burden of Proof*

The parties submitted this matter to the trial court largely on stipulated facts. They do not dispute that the applicable standard of review in this matter is de novo. We agree. As one court succinctly puts it, "It is well established that the application of a taxing statute to stipulated facts is a question of law to be determined by the appellate court." (*Gray v. Franchise Tax Board* (1991) 235 Cal.App.3d 36, 40.)

"In a suit for tax refund, the taxpayer has the burden of proof; he must affirmatively establish the right to a refund of the taxes by a preponderance of the evidence." (*Gray v. Franchise Tax Board, supra,* 235 Cal.App.3d at p. 40.) Further, "[t]he taxpayer must not only prove that the tax assessment is incorrect, but also he must produce evidence to establish the proper amount of the tax. [Citations.]" (*Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 744.)

B. *Right to a Refund Under Applicable California Taxing Statutes*

Pacific Telesis argues that it should not have reported and paid tax on the deferred gain on the Western Electric Equipment Sales in its 1987-1990 tax returns. In fact, Pacific Telesis argues, these deferred gains should have been reported, and the entire tax on these gains paid, in 1983 in AT&T's combined report, when Pacific Bell left the AT&T group. Pacific Telesis argues that it therefore had no obligation, after the breakup of the AT&T group, to report or pay tax on the deferred gains on the Western Electric equipment sales and is entitled to a refund of the taxes it paid under its earlier returns filed with the Franchise Tax Board. We disagree.

In advancing this contention, Pacific Telesis cannot point to any applicable California statute or regulation that *required* AT&T to report the Western Electric equipment sales in its 1983 combined report. Instead, Pacific Telesis's argument that AT&T, rather than Pacific Telesis, should have reported the income from these sales rests on a Franchise Tax Board publication and on a federal tax regulation. Neither of these establishes that AT&T was bound to report the Western Electric equipment sales gains in its 1983 California combined tax return or that Pacific Telesis erred when it reported the remaining deferred gain on these sales after AT&T's breakup.

FTB Publication 1061, on which Pacific Telesis relies, is entitled "Instructions for Corporations Filing a Combined Report." It states that "[w]hen either the seller or purchaser is eliminated from the combined group, or the group for any reason terminates combined reporting, the gain or loss is reportable by the seller at a time immediately preceding the date either corporation ceased to be a member of the group."

The parties discuss at length whether, under the instructions set out in this publication, Pacific Telesis is correct in asserting that Western Electric Company, as the seller of the equipment, properly would have borne the entire tax burden of the equipment sales. We need not answer this question because FTB Publication 1061 is simply not an enforceable taxing statute and in no way dictates the appropriate method for reporting the gains from the Western Electric equipment sales. This publication is not a statute or an administrative regulation. Rather, it is an instruction booklet, generally available to the public. It is a general principle of tax law that instruction booklets such as this one "are simply guidelines for taxpayers and do not bind [the government] in subsequent litigation." (*CWT Farms, Inc. v. Commissioner of Internal Revenue* (11th Cir. 1985) 755 F.2d 790, 803; *Adler v. Commissioner of Internal Revenue* (9th Cir. 1964) 330 F.2d 91, 93; *Jones v. State of Georgia Department of Revenue* (Bankr. N.D.Ga. 1993) 158 B.R. 535, 538.) This instruction booklet, therefore, does not establish that Pacific Telesis's 1987-1990 reporting of the Western Electric equipment sales was in error.

Pacific Telesis also cites federal Treasury Regulation section 1.1502-13(f)(1)(iii) in support of its argument that the remaining gains on the Western Electric equipment sales should have been reported in 1983 by AT&T. This federal Treasury Regulation does not bind either the Franchise Tax Board or Pacific Telesis. Certainly, we may look to the federal taxing statutes and regulations as "relevant history for aid in construing our state taxing statutes" (*Estate of Giolitti* (1972) 26 Cal.App.3d 327, 336), but we are not required to do so. It is only "[i]n instances where federal law and California law are the same [that] rulings and regulations dealing with the IRC are persuasive authority in interpreting the California statute." (*J.H. McKnight Ranch, Inc. v. Franchise Tax Bd.* (2003) 110 Cal.App.4th 978, 984, fn. 1.) Here, of course, federal and California law on this subject are not the same because, in 1983, no California statute or regulation prescribed any specific method for reporting the gain from intercompany transactions occurring within a unitary group. Nor was there any statute or regulation that prescribed how these gains should be reported upon the termination of the unitary group.

In the absence of any California statute or regulation on this subject, Pacific Telesis and the Franchise Tax Board agreed on a method for reporting and taxing the Western Electric equipment sales that was acceptable to all concerned. Under this method, the Franchise Tax Board permitted Pacific Bell, and Pacific Telesis after it, to report the income from the Western Electric equipment sales in a manner consistent with the agreement reached between these companies and the federal government.[3]

Pacific Telesis has not shown that this arrangement violated any California statute or regulation. Although the parties do not discuss the source of the Franchise Tax Board's authority to permit such an arrangement, it would seem to lie in the Board's considerable discretion to enforce California's franchise tax requirements. (Rev. & Tax. Code, § 19503, subd. (a).) As one court has explained, the Board's power to prescribe necessary rules and regulations, involves "concepts that are flexible and relative, deriving substance from context and application. A rule deemed 'necessary' for achieving a particular result may work in one setting but not in another. A regulation that is considered 'reasonable' for one subject can lose this status if transferred to a different area. The differentiation between 'necessary' and 'unnecessary,' between 'reasonable' and 'unreasonable,' requires the exercise of discretion." (*Sklar v. Franchise Tax Board* (1986) 185 Cal.App.3d 616, 623.) Generally, the Board's discretionary determinations can only be challenged if they are unreasonable or arbitrary. (*Chase Brass & Copper Co. v. Franchise Tax. Bd.* (1977) 70 Cal.App.3d 457, 468.) Pacific Telesis has not

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[3] At oral argument, Pacific Telesis's counsel asserted that it is seeking this tax refund because it made a "mistake" in its reporting of the gains from the Western Electric equipment sales in returns it filed between 1987 and 1990. This argument is disingenuous at best. At the same time it was filing these "mistaken" returns, Pacific Telesis was negotiating a closing agreement with the Franchise Tax board, similar to the agreement it had reached with the Internal Revenue Service, which would memorialize and effectuate precisely this arrangement. Although the Franchise Tax Board and Pacific Telesis ultimately failed to enter into such an agreement, there is absolutely no indication that this occurred because Pacific Telesis believed this reporting method, which was similar to its arrangement with the federal government, was a "mistake."

We note, too, that, although such an agreement would have been desirable and would have prevented this litigation, such an agreement was not mandated. In contrast, as the Board points out, a closing agreement with the Internal Revenue Service *was* necessary because unlike California law, federal regulations (Treas. Regs. § 1.1502-13) required a specific method for reporting gain from intercompany transactions. Because Pacific Telesis wished to depart from this method, a closing agreement was required.

established that there was anything unreasonable or arbitrary about the Board permitting it to file tax returns in a manner consistent with the returns Pacific Telesis was already filing with the federal government. In sum, Pacific Telesis has not met its burden of proof that this method of reporting was contrary to existing California law and, therefore, Pacific Telesis is not entitled to a refund.

C. *Equity and Good Conscience*

There is yet a second reason supporting affirmance of the trial court's judgment. A tax refund claim is essentially a claim in restitution and is governed by equitable principles. Among these is the general rule that, before a refund will be ordered, the taxpayer must show that "more has been exacted than in equity and good conscience should have been paid." (*Sprint Communications Co. v. State Bd. of Equalization* (1995) 40 Cal.App.4th 1254, 1259; *Pacific Fruit Express Co. v. McColgan* (1944) 67 Cal.App.2d 93, 96; see also Rest.3d Restitution & Unjust Enrichment (T.D. No. 1, 2001) § 19, com. (d) ["inherent equitable appeal of a claim in restitution to recover improper tax payments is widely acknowledged."].)[4]

We have little difficulty in concluding that Pacific Telesis has utterly failed to show that it paid more taxes than should have been paid, in "equity and good conscience." For 27 years, Pacific Bell accounted in California for the gains on Western Electric equipment sales under agreements it reached with the federal government, agreements which were entered into in order to benefit Pacific Bell ratepayers. When it was too late for the Franchise Tax Board to seek payment from any other member of the

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[4] The consideration of what a party is required to do "in equity and good conscience," occurs in many contexts. For example, our Supreme Court recently and at length discussed the concept as it applies to "equitable adoption" which, "'requires some form of agreement to adopt, coupled with subsequent objective conduct indicating mutual recognition of an adoptive parent and child relationship to such an extent that in equity and good conscience an adoption should be deemed to have taken place.'" (*Estate of Ford* (2004) 32 Cal.4th 160, 168.) The court noted that this concept, "even in California, rested less on ordinary rules of contract law than on considerations of fairness and intent . . . ." (*Id* at p. 169.)

former AT&T entity for taxes owed on these equipment sales, Pacific Telesis argued *for the first time* that the gains from the Western Electric equipment sales should have been reported in their entirety in 1983 and it had no obligation to pay the tax it had earlier agreed to pay.

In a similar case, *John Deere Company v. Franchise Tax Board* (1965) 237 Cal.App.2d 663 (*John Deere*), the court of appeal considered a tax refund request by subsidiaries of the John Deere Company, who were part of a unitary business. (*Id.* at p. 664.) The Franchise Tax Board computed taxes owed by the unitary business over a 13-year time period. As it did so, the Board engaged in extended communications with the parent corporation. At the end of this process, the Board issued notices of assessments stating that assessments would be levied against one of two California subsidiaries, unless the parent company preferred a different allocation. The parent company did not request a different allocation. Several years later, the subsidiary against which the tax had been assessed objected for the first time to this allocation. In the meantime, the statute of limitations for seeking a different assessment had run. (*Id.* at pp. 664-665.)

The trial court concluded that the parent company as well as the California subsidiaries had "all consented to the assessment of taxes . . .; that none of them objected, either orally or in writing, to that method of assessment until after separate assessments to [another subsidiary] for the share attributable to it were barred by the statue; and that defendant board reasonably relied, to its detriment, upon this failure to object." (*John Deere, supra,* 237 Cal.App.2d at p. 665.) The court of appeal agreed. In so doing it noted that there was "no dispute that the amount assessed to [one of the two California subsidiaries] is properly due from the California operation of the Deere unitary group. We do not apply a rule of formal estoppel. We do point out that a taxpayer seeking a refund may recover only if it be shown that more taxes have been exacted than in equity and good conscience should have been paid." (*Id.* at pp. 665-666.)

Here, too, Pacific Telesis consented to the assessment of taxes it now challenges. In fact, this manner of assessment was agreed upon in order to benefit Pacific Bell ratepayers. There is no dispute that the State of California is entitled to collect taxes on the gain from the Western Electric equipment sales and that, at no time before the statute of limitations had run on reassessing the amounts due, did Pacific Telesis dispute the method of reporting this gain. In light of these facts, Pacific Telesis has failed to show that more taxes were exacted than in equity and good conscience should have been paid.

Pacific Telesis attempts to distinguish *John Deere* on the ground that the taxpayer in *John Deere* had an affirmative obligation to respond to the Board's assessment and that its failure to meet this obligation was the basis of the court's ruling. This argument is not persuasive. The administrative process in *John Deere* did not place an "affirmative obligation" on the taxpayer to respond that differs materially from the obligation on Pacific Telesis to inform the Board that the method of taxation it had originally utilized was no longer acceptable to it.

Pacific Telesis also argues that the trial court could not take into consideration the amount of tax owed in 1983, because the Board was barred from seeking any further assessments for this year. Pacific Telesis suggests that the only way the trial court could consider the 1983 tax year was through the affirmative defense of equitable recoupment. Pacific Telesis further asserts that the Board did not plead the affirmative defense of equitable recoupment and the elements of this defense have not been met and, therefore, the court could not take into account the 1983 tax year. We disagree.

The question before the trial court was whether the taxpayer paid more than "in equity and good conscience" it should have. In considering this question, the doctrine of equitable recoupment is irrelevant.[5] Whatever the merits of this defense, the trial court's decision turned on whether Pacific Telesis had met *its* burden of proof, not whether the Franchise Tax Board established the defense of equitable recoupment. In determining

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[5] The doctrine of equitable recoupment is an affirmative defense that provides that a taxing agency may set off the amount of tax underpayment in one year, even if barred from collecting that underpayment by the statute of limitations, against a tax refund request. In order to establish entitlement to this defense, the taxing agency must show that a single transaction or taxable event has been taxed twice to the same taxpayer on inconsistent legal theories. (*Rothensies v. Electric Storage Battery Co.* (1946) 329 U.S. 296.)

whether Pacific Telesis had met its burden of showing it paid more in equity and good conscience than it should have, the court properly considered Pacific Bell's total tax liability for the Western Electric equipment sales, including liability in years in which the statute of limitations for assessing taxes had passed (including 1983).

In so doing, the court did not apply the affirmative defense of equitable recoupment. It applied equity. As the trial court appropriately phrased it: "In order to determine whether a taxpayer is entitled to take a deduction in a particular year, or is entitled to have the subject of the deduction treated in another manner for tax purposes, the genesis and history of the deduction logically must be examined. And, under principles of equity, the law is not like a horse with blinders viewing only the spot directly in front of its nose; rather, equity requires an examination of the entirety of the circumstances to ensure a result that satisfies the intent of legal mandate as well as fairness. It is Pacific Telesis that puts tax year 1983 at issue with its assertion that the remaining taxes on the [Western Electric] gain should have been paid in that year. Therefore, it is both logically and equitably appropriate to examine what Pacific Bell's tax liability would have been for tax year 1983 if the remaining gain had been accounted for in that tax year." The trial court did not err in concluding that Pacific Telesis was not entitled to a refund.[6]

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[6] In light of our conclusion, we do not consider whether the trial court erred in holding that Pacific Telesis was not entitled to a refund under four affirmative defenses asserted by the Franchise Tax Board.

IV. DISPOSITION

The judgment is affirmed.

Haerle, J.

We concur:

Kline, P.J.

Ruvolo, J.